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Before the
Federal Communications Commission
Washington, DC 20554

In the Matter of	)	
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Transport Rate Structure and Pricing	)	CC Docket No. 91-213
	)	
End User Common Line Charges	)	CC Docket No. 95-72

REPLY TO OPPOSITIONS TO
PETITION FOR RECONSIDERATION
OF THE RURAL TELEPHONE COMPANIES

The Rural Telephone Companies (RTCs), by their attorneys and pursuant to 47 C.F.R. §1.429, respectfully submit this Reply to Oppositions to its Petition for Reconsideration of the Commission's *Report and Order*,[1] and *Order on Reconsideration*[2] in CC Docket No. 96-54.

The Total Effect of the USF Order Is Confiscatory

In its Petition for Reconsideration (hereinafter "the Petition"), the RTCs demonstrated that the "total effect" of the new USF plan reduces the RTCs' interstate rate-of-return to confiscatory levels in violation of the takings clause of the Fifth Amendment to the Constitution. For example, the RTCs provided evidence that the Commission's interim plan, which includes a cap on Corporate Operations Expense, would generate confiscatory interstate rates-of-return as

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[1] 62 Fed. Reg. 32862 (June 17, 1997) (*USF Order*).

[2] Federal-State Joint Board on Universal Service, *Order on Reconsideration*. CC Docket No. 96-45, FCC 97-246, (released July 10, 1997) ("*USF Recon. Order*").

low as -28.84 %.[3] If the inevitable customer losses are factored in, the impact of the interim plan results in even greater confiscation. Assuming that the RTCs lose just 25 % of their customer base, these companies would experience interstate rates-of-return as low as -47.37 %.[4]

The RTCs also demonstrated that the long-term impact of the transition to a forward-looking economic cost (FLEC) model will also result in confiscatory interstate rates-of-return.[5] The analysis estimates forward looking costs using Commission-adopted Part 51 cost proxies which, according to the Commission, "will result in reasonable price ceilings or price ranges...designed to approximate prices that will enable competitors to enter the local exchange market swiftly and efficiently...."[6] Applying this FLEC methodology and assuming that the Commission funds the program as proposed at only 25% of the total support necessary, the RTCs project negative rates-of-return between -12.3 % and -61.89%.[7] Significantly, none of the parties filing comments or opposition to the RTCs' Petition take issue with the methodology utilized to demonstrate the severe impact of the interim rules or the result of the transition to a FLEC methodology.

MCI, however, attempts to introduce its own legal standard for evaluating the Commission's action which is unsupported by relevant precedent.[8] As stated in the Petition, a

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[3] Petition at 4-5.

[4] *Id.* at 5.

[5] *Id.*

[6] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, *First Report and Order*, 11 FCC Rcd 15499, ¶782 (1996) (Local Competition Order) *vacated in part sub nom. Iowa Util. Bd. v. FCC,* 1997 WL 403401 (8th Cir. filed July 18, 1997).

[7] Petition at 5.

[8] MCI at 4.

rate is confiscatory if the total effect of the rate order is not "just and reasonable."[9] To determine whether a rate order is just and reasonable *Hope Natural Gas* requires the Commission to "balance the interests of both the investor and consumer."[10] The Court indicated that, from the investor or company point of view, it is important that there be enough revenue for operating expenses and for the capital costs of the business. From the consumer's point of view, the return on equity should be "commensurate with returns on investments in other enterprises having corresponding risks."[11]

MCI wholly misstates the standard set in *Hope Natural Gas* and ignores the requirement that the Commission conduct this balancing of interests. Thus, MCI's objections to the RTCs' use of the Commission-established "just and reasonable" rate-of-return as a measure of the confiscatory nature of the *USF Order* must be rejected. The FCC's current target rate-of-return for the RTCs is the appropriate measure to demonstrate the impact of the USF Order. The 11.25% target rate-of-return was set and has been maintained by the Commission for the LEC industry to "strike a viable and sustainable balance between ratepayer and shareholder interests,"[12] precisely the balancing required by *Hope Natural Gas*.[13]

Moreover, the financial community is well aware of the rate-of-return system under which the RTCs are regulated and will measure the future risk facing these companies based on

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[9] *Hope Natural Gas,* 320 U.S. 602-603*; see also Duquesne Light Company v. Barasch,* 488 U.S. 299, 312 (1989); *In re Permian Basin Rate Cases,* 390 U.S. 747 (1968); *Federal Power Commission v. Memphis, Gas & Water Division,* 411 U.S. 458 (1973); *Jersey Central Power & Light v. FERC,* 810 F.2d 1168 (D.C. Cir. 1987).

[10] *Hope Natural Gas*, 320 U.S. at 602.

[11] *Hope Natural Gas,* 320 U.S. at 602; *See also, Duquense Light*, 488 U.S. 299, 312.

[12] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Memorandum Opinion and Order,* 5 FCC Rcd 7507, ¶216 (1990).

[13] *Hope Natural Gas*, 320 U.S. 591, 602 (stating "...the fixing of 'just and reasonable' rates, involves the balancing of investor and consumer interests").

that system. Indeed, as the Court stated in *Duquesne Light Company*, "the impact of certain rates can only be evaluated in the context of the system under which they are imposed."[14] Accordingly, as measured by this system, the RTCs have demonstrated that the regime established by the USF Order is confiscatory because it will require the RTCs to operate with substantial losses and, further, will prevent them from continuing to attract investment.

As indicated above and in their Petition for Reconsideration, the RTCs provide substantial evidence of the unjust consequences of the USF Order and the Commission's failure to strike the proper balance as required by *Hope Natural Gas*. The RTCs have not argued, as MCI claims, that the current rate-of-return of 11.25% represents a "Constitutional floor," below which rates are automatically confiscatory.[15] The RTCs do not claim 11.25% as a floor. As MCI should know, the 11.25% rate-of-return is but a target within a Commission-determined "zone of reasonableness" (10.85% - 11.4%),[16] and as the RTCs have demonstrated, the Commission's action will result in interstate rates-of-return far below even this identified zone.[17]

MCI's contention that the Commission should consider the impact on both intrastate and interstate operations in determining whether its USF Order will effect a taking is erroneous.[18] The RTCs' demonstration of the impact of the Commission's regulatory framework is necessarily limited in its consideration to the RTCs' rates for services under the Commission's

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[14] *Duquesne Light Company*, 488 U.S. 299, 314 (1989).

[15] MCI at 2.

[16] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, *Memorandum Opinion and Order*, at 7532.

[17] *AT&T v. FCC*, 836 F.2d 1386 (1988), *citing Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987) (court may overturn rate that lies outside the "zone of reasonableness").

[18] MCI at 4.

jurisdiction and, contrary to MCI's claims, must not take into account services outside the Commission's jurisdiction.[19]

MCI and General Communications, Inc. do not want the RTCs to continue to earn a reasonable return on their embedded investment.[20] These interexchange carriers ("IXCs") must be reminded that Section 205 of the Act[21] and the Commission's rules *still* allow the RTCs, as rate-of-return regulated carriers, to earn a just and reasonable rate-of-return on their booked costs.[22] As the RTCs have demonstrated, the Commission's interim rules, *i.e.*, changes to DEM weighting allocation rules and the cap on corporate operations expense, are inconsistent with these provisions. Indeed, prior to setting the rates of a regulated carrier, at minimum the Commission must determine the rate base upon which rates can be set.[23] With the *USF Order*, the Commission has effectively reestablished the RTCs' interstate rate-of-return at confiscatory levels without actually considering the rate base upon which these companies may earn a just-and-reasonable return.[24] If, in fact, the Commission's action signals an immediate end to the currently prescribed regulated rate-of-return, the Commission has not indicated as much, and it would be arbitrary and capricious to give the *USF Order* such an effect.[25]

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[19] *Smith v. Ill. Bell*, 282 U.S. 133 (1930) (Illinois State Commission's consideration of the confiscatory nature of a rate order is limited to consideration of the impact on the intrastate business); *See also Local Competition Order, supra* fn. 6 at 15871.

[20] MCI at 4, General Communications, Inc. at 9.

[21] 47 U.S.C. § 205.

[22] *See gen.* 47 C.F.R. Part 65.

[23] *Williams v. Washington Metropolitan Area Transit Commission,* 415 F.2d 922, 935 (D.C. Cir. 1968); *Commonwealth Teleph. Co. v. Wisconsin Pub. Service Comm.*, 32 N.W. 2d (1948). *See also New England Teleph. & Teleg. Co. v. State*, 64 A. 2d 9 (1949); *Milwaukee & Suburban Transp. Corp. v. Wisconsin Pub. Service Comm.*, 108 N.W. 2d 729 (1961).

[24] *Id.*

[25] *See Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971)(when agency changes its course[, it] must supply a reasoned analysis indicating that prior policies and

Moreover, the arguments disputing the RTCs ability to include booked costs in their rate base generally miss the point with respect to the holding in *Hope Natural Gas* because these parties are focused on the methodology for determining the rate base when only the end results of the ratemaking are to be considered.[26] That a particular ratemaking standard, *i.e.*, one that is based on something other than booked costs, may be adopted does not *per se* justify the end result it produces particularly when, as the RTCs have demonstrated, the result of the ratemaking is confiscatory.[27]

In addition, MCI relies on cases that are factually distant from the case at hand. For example, MCI cites to *Duquesne Light Co. v. Barasch*[28] in which the Supreme Court upheld the exclusion of historic costs of abandoned nuclear power plants that were never "used and useful in the service to the public" and which resulted in only a slight reduction in Duquesne's rate-of-return.[29] *Duquesne* is useful because it applies the *Hope* standard. But the fact that the Court did not find a taking there has no bearing on the RTCs' petition. Unlike the impact of the *USF Order* on the RTCs, the total effect of the regulator's action in *Duquesne* was minimal.[30] Moreover, in *Duquesne* the Court disallowed costs because they were not "used and useful." By Commission regulation, the RTCs can only book investments that are "used and useful in the

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standards are being deliberately changed, not casually ignored...."

[26] MCI at 3-8.

[27] *Jersey Cent. Power & Light Co. v. F.E.R.C.*, 810 F.2d 1168, 1180 (D.C.Cir 1987) (citing *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968).

[28] *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989).

[29] *Id.* at 304.

[30] *Id.* at 310-311.

efficient provision of interstate telecommunications service."[31] Most significantly, unlike the utilities in Duquesne, the RTCs have demonstrated that the total effect of the Commission's action will lead to reductions in the RTCs' rates of return, in some instances, of over 50 percentage points, whereas in Duquesne, the utilities realized no significant impact on their bottom line.

MCI's reliance on *Market St Ry. Co. v. Railroad Comm'n*[32] is even less appropriate. This case involved a street car company that, at the time of the Court's ruling, had been sold to the city government. The Court upheld the valuation of the company at the offered purchase price, in part because much of the company's assets, *i.e.*, street cars, were not in service to the public due to a combination of mismanagement and a wartime shortage of replacement parts. In fact, the Court determined that the takings standard of *Hope Natural Gas* was "obviously inapplicable to [the street car company] whose financial integrity [was] already hopelessly undermined."[33]

The 25/75 High Cost Funding Scheme is Arbitrary and Capricious

The Commission's decision to fund only 25 percent of the federal USF associated with the recovery of local switching investment via DEM weighting, high cost loop support and the long term support for NECA's carrier common line pool was made without any assurance that the states are willing and capable of funding the remaining necessary support amounts. With good reason, several States in Petitions for Reconsideration or Comments express their fears that

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[31] *See* 47 C.F.R. § 65.800. ("The rate base shall consist of the interstate portion ... that has been invested in plant used and useful in the efficient provision of interstate telecommunications services regulated by [the] Commission...").

[32] *Market St Ry. Co. v. Railroad Comm'n*, 324 U.S. 548 (1945).

[33] 324 U.S. 548, 566.

the federal funding level will lead to significant local rate increases.[34] The disparate impact demonstrated by several states adds support to the RTCs' determination that the FCC's action: (1) will put significant upward pressure on local rates; and (2) will create a patchwork of unfunded and under-funded high cost areas, at odds with Section 245(b)(3) of the Act.

DEM Weighting Separations Rules Are Not a Subsidy

In the Petition, the RTCs explained that DEM weighting is an appropriate separations mechanism because small incumbent local exchange carriers' ("ILECs") local switching costs are driven by the IXCs' need to have equal access, intraLATA toll dialing parity and advanced features. Unfortunately, the Commission's interim local switching rules ignore this fact and arbitrarily treat DEM weighting as a "subsidy" to be borne by all USF contributors rather than assigning the costs to the cost-causer. Contrary to the position taken by USTA and MCI, converting the DEM weighting separations rules to USF support does not provide the RTCs with any incentive to continue to invest in switching capability and other advanced telecommunications services when effective January 1, 1998, the support will be capped at 1996 levels and, moreover, will be portable.[35]

Cap On Corporate Operations Expense Is Arbitrary and Capricious

In their Petition, the RTCs demonstrated that the Commission arbitrarily arrived at the cap on Corporate Operations Expense without first making any determination that expenses for ILECs serving high cost areas were unreasonable or excessive. Contrary to MCI's assertions and given the fundamental changes in the RTCs' operations brought about by the 1996

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[34] *See e.g.*, Consolidated Opposition and Comments of the State of Alaska at 6 (local ratepayers will experience $10 per month surcharge); *see also* Petition for Reconsideration and Clarification of Vermont Public Service Board at Attachment A (predicting intrastate rate increases as much as $20.57).

[35] USTA at 2; MCI at 12.

Telecommunications Act, Corporate Operations Expenses are hardly "discretionary" and should be considered inherent in the provision of universal service. As pointed out by the RTCs, the cap on these expenses could not come at a more inopportune time because implementation of new Commission policies on interconnection, access charge reform, and universal service require the RTCs to incur greater expenses for, *e.g.* network planning, procurement, research and development, and information to ensure that the RTCs' networks are designed in a manner that will ensure the continuation of quality universal service in a competitive environment. Thus, contrary to General Communications, Inc.'s claims, facilitating greater recovery of Corporate Operations Expenses will promote rather than deter competition because it will ensure that the smallest ILECs have the proper resources to design and operate their network so as to effectively compete with large CLECs, such as MCI/British Telecom, AT&T and Worldcom/Metropolitan Fiber.

It Is Contrary to Statutory USF Goals to Limit the High Cost Loop Recovery When a Rural Exchange Is Acquired and Upgraded.

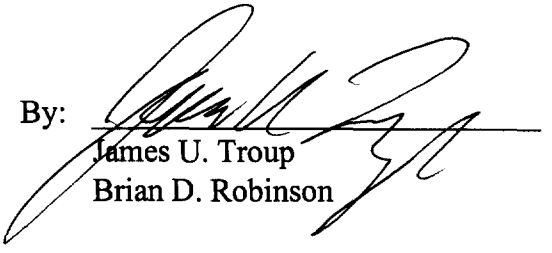
The RTCs request reconsideration of the decision to limit USF support for acquired rural exchanges because it discourages investment in switching and network upgrades in rural America contrary to Section 254(b) universal service principles and contrary to Section 7 of the Act. In their Petition, the RTCs point out that, but for incentives created by available USF, many rural areas would still be stuck with multi-party service provided over obsolete analog facilities staffed by people hundreds of miles from the exchange area. The Commission's decision to limit USF on acquired exchanges forces many rural subscribers to remain technology "have-nots." Bell Atlantic mistakenly asserts that USF inflates the purchase price of rural exchanges.[36]

[36] Bell Atlantic at 6-7 and MCI at 14.

However, the Commission's rules and study area waiver process prevent this result because they check an ILEC's ability to record the purchase of telecommunications plant at above fair market value.[37] Accordingly, rather than rely on a blanket prohibition, the Commission should continue to use existing procedures to evaluate transactions and thereby foster the proper incentive for rural ILECs to improve service on a case-by-case basis.

For the reasons set forth herein, and set forth in the RTCs' Petition for Reconsideration, the RTCs respectfully request that the Commission reconsider its USF Order, and USF Recon. Order.

The Rural Telephone Companies

By: 
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September 3, 1997

[37] 47 C.F.R. § 32.2005.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on September 3, 1997, a copy of the foregoing REPLY TO OPPOSITIONS TO PETITION FOR RECONSIDERATION OF THE RURAL TELEPHONE COMPANIES was delivered by first-class mail, postage paid to the following:

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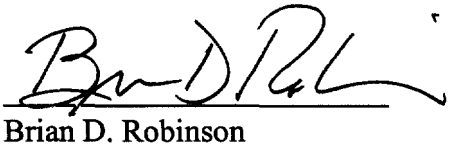

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